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RUEHKP/AMCONSUL KARACHI 2414
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UNCLAS SECTION 01 OF 05 COLOMBO 001123

SENSITIVE

SIPDIS

STATE FOR SCA/INS AND EEB/IFD/OMA
STATE PASS USTR FOR ADINA ADLER AND VICKY KADER
COMMERCE FOR EROL YESIN, BRIAN WILLIAMS
DOL/ILAB FOR TINA MCCARTER
TREASURY FOR ANNE ALIKONIS

E.O 12958: N/A
TAGS: ECON EFIN PGOV MARR KMCA CE
SUBJECT: SRI LANKA PASSES 2009 BUDGET

REF: COLOMBO 1107

¶1. Summary: (SBU) Parliament easily passed the 2009 GSL budget on December 8, one month following President Rajapaksa's presentation of the draft on November 6. This is Rajapaksa's fourth budget since coming into office in 2005 on a platform of poverty reduction, steering investment to disadvantaged areas, developing small and medium enterprises, promoting agriculture and expanding the government. The 2009 budget is a continuation of these policies with a renewed stress on the need to defeat terrorism, bring development to the north and east, and improve local production. The overly optimistic budget, which forecasts increases in expenditure ($11 billion) and revenue ($7.8 billion), as well as a resulting deficit equal to 6.5% of GDP ($3.1 billion), fails to realistically take into consideration changes in the global market due to the economic downturn. Although the budget review process was much smoother in 2008 than in previous years, passing with 126 votes in favor and 84 against, opposition party UNP demonstrated its displeasure by issuing its own 2009 budget draft and circulating it among the media. End summary.

2009 -- MORE SPENDING, LOWER DEFICIT

¶2. (U) FISCAL DATA, 2008-2009-Economic Format: Comparison between the proposed 2008 budget, the revised 2008 budget, and the proposed 2009 budget. Figures in parentheses represent the percentage of GDP. Sources: 2008 and 2009 Budget speeches.

Year	2008 Proposed	2008 Revised	2009 Proposed
Billions of rupees			
Total Expenditure	1044 (24)	1016 (23)	1192 (22.8)
-current	713	743	823
-capital	335	278	371
-other	-4	-5	-3
Total Revenue	751 (18)	709 (16)	855 (16.4)
Current AC			

Surplus/Deficit	+38 (0.9)	-34 (0.8)	+32 (0.2)
Budget Deficit	293 (7.0)	307 (7.0)	337 (6.5)
GDP Growth rate	7.5%	6.5%	6.8%

¶3. (U) The 2009 budget forecasts large increases in both expenditure and revenue. These increases are in line with inflation, currently at 16.3 percent following a high of 28 percent earlier this year. In comparison with the 2008 revised budget, total government spending will increase 17 percent to 1.191 billion rupees (Rs) ($11 billion) and revenue will rise 21 percent to Rs 855 billion ($7.8 billion), resulting in a deficit of Rs 337 billion ($3.1 billion). The deficit is equal to 6.5 percent of GDP, lower in comparison to recent deficits of more than 7.0 percent of GDP. However, these estimates should be viewed skeptically as the final numbers are traditionally quite different from the forecasts.

¶4. (SBU) The budget lacks any expenditure rationalization efforts. Recurrent expenditure on interest payments, salaries, pensions, subsidies, and welfare payments will make up nearly 70 percent of government expenditure in 2009. The remaining 30 percent is meant for capital investment. However, since most of capital expenditure is financed from foreign borrowing, it is likely that 2009 capital spending will be significantly reduced due to current global financial constraints. Also, it is customary in Sri Lanka for recurrent expenditure to rise and the capital expenditure to fall late in the year. The Central Bank's head of research, P N Weerasinghe, stated publicly that while he does not see a risk in funds expected from donors such as the World Bank, Asian Development

Bank, Japan, Iran and China, about $500 million in commercial financing to provide counterpart funds for development projects may not fully materialize. Others at the Central Bank remain very concerned about the difficulty to raise financing in 2009.

¶5. (U) It is unlikely, as in the previous years, the government will meet revenue targets. Therefore, the government forecast of a 20 percent increase in revenue in 2009 is overly optimistic. Revenue shortfalls are very likely given the global slowdown and its effects on Sri Lankan economy.

¶6. (U) In late 2008 the government reduced capital expenditure drastically in order to keep the deficit intact at 7 percent of GDP. Soon after the initial November 6 budget presentation, the Treasury imposed a spending freeze for the remainder of the year. Revenue was also much lower than targeted in 2008. Similar and additional cutbacks will be required early in 2009 if the government hopes to achieve its proposed deficit of 6.5 percent of GDP.

¶7. Note: The economic format of the budget does not include debt service (principle payments) of Rs 383 billion ($3.5 billion) in 2008 and 476 billion ($4.37 billion) in 2009. Total funding requirement including debt roll over will be Rs 813 billion ($7.4 billion) in 2009.

DEFENSE SPENDING
REACHES USD 1.6 billion

¶8. (U) Sri Lanka - Defense budget 2006-09

	2006	2007	2008	2009
		Rev. est.		
Defense (Rs billion)	104.8	155.7	194	177
($ billion)	1.0	1.4	1.8	1.6
As percent				
of GDP	3.6%	4.4%	4.4%	3.4%
of govt expenditure	14.7%	18.2%	19.1%	14.8%

Source: Budget estimates 2008 and 2009, Fiscal Management Report 2009

¶9. (U) A significant expenditure item in 2009, and a key focus for the government, is financing for the war. Military spending in 2009 is budgeted at Rs 177 billion ($1.6 billion), or 3.4 percent of GDP and 14.8 percent of the total budget. This actually represents a 9 percent decrease from 2008 defense expenditures when compared with the revised 2008 budget forecast of Rs 194 billion ($1.8 billion). With the 2009 figures, the Rajapaksa administration's defense spending since coming to power in late 2005 is nearly USD 6 billion.

¶10. (U) Rajapaksa's November 6 budget speech focused heavily on government efforts to fight terrorism and liberate the north and east, and the President once again called on the LTTE to lay down arms and join the democratic process. In justifying large defense expenditures throughout the last three years and in particular in this budget, Rajapaksa said "we view such expenditure as a priority need towards establishing a stable economic environment to restore democracy, consolidate human rights, and achieve economic development... A country that is free of terrorism is also the prime need of private sector investors." Rajapaksa also highlighted and reminded the country of the sacrifices made by soldiers fighting in dangerous conditions. Salaries of soldiers were increased by Rs 2,000 ($18.37) per month. A further Rs 3.5 billion ($31.8 million) was allocated to build houses for them.

FOR THE LITTLE PEOPLE, AND KEY INDUSTRIES

¶11. (U) The budget offers some relief to various constituencies, but not by enough to meet expectations or challenges posed by inflation

and global economic turmoil. It provides a Rs 1,000 ($9) per month salary increase to government servants and a Rs 560 ($5) per month pension increase. This, combined with the salary increase for soldiers, will cost Rs 22.5 billion ($200 million) or about 2 percent of total expenditure in 2009. The tax burden of the private sector workers was reduced slightly by widening the tax brackets. In addition, the maximum tax rate for resident Sri Lankans providing international professional services was reduced from the current 35 percent to 20 percent. The budget increased taxes on a range of imports, a measure expected to aid local farmers and producers and save foreign exchange. In addition, fuel prices were reduced slightly, but not enough to be in line with current world market prices. Low income families will be given a monthly allowance of Rs 200 ($2) for children under 5 years to buy milk powder. Discounts on electricity and water bills will be given to low income earners.

¶12. (U) The budget also offers some relief to key industries -- in particular tea, tourism and garments -- by providing a reduction in electricity tariffs applicable to tourist hotels, reductions in the price of furnace oil, a six month moratorium on loan repayments to export industries, export marketing assistance, a treasury guarantee for tea exported on credit terms, and a new fertilizer subsidy for small tea growers. It is unclear how some of these programs, such as the debt moratorium and the tea export credit, will be implemented.

¶13. (U) Rajapaksa's budget introduces new tax increases meant to protect local industries. For example, import taxes increased on numerous products, including: wheat grain; wheat flour; imported grains; sugar; milk; fruits and vegetables (excluding apples); animal feed; paper; furniture; confectionary; salt; footwear and other leather products; clothing; and electrical items. Taxes on some imports, already at more than 100 percent, increase further with these taxes. Unfortunately, as highlighted by Ernst and Young Colombo senior partner Lakmali Nanayakkara, the new taxes make import tax calculation even more complicated, as nearly 10 different taxes and duties are levied on various bases.

TAX BURDEN INCREASING

¶14. (U) While Sri Lanka's tax system is already exceptionally

cumbersome, Rajapaksa introduced yet another new tax, the Nation Building Tax (NBL), further complicating the tax system. Rajapaksa said the new tax should be considered as a "social contribution" to rebuild communities and damaged infrastructure in the north and east and to provide welfare for security forces. This one percent tax will apply on imports, domestic production and services; it will be in effect for two years. The finance sector, which is already taxed at over 70 percent, is excluded. Parliament must still pass legislation to enact this tax. In addition, the maximum liability of the Economic Service Charge increased, the telephone tax was extended from mobile services to fixed line, and the port and airport tax on imports has increased from 3-5 percent.

¶15. (SBU) In a half-hearted bid to address business concerns, the budget proposes to appoint a (unfunded) Presidential Task Force to prepare a people friendly tax policy by 2010. The government did reduce the standard Value Added Tax (VAT) rate from 15 percent to 12 percent, with the aim of reducing the cost of living. The 18 percent VAT on luxury items remains unchanged. However, tax experts have said that the reduction in VAT will not provide much relief as the new National Building Tax and higher import duties will make up for the reduction. According to GSL estimates, the VAT reduction is estimated to cost the government Rs 45 billion ($409 million). Increases in other taxes are expected to bring Rs 75 billion ($681 million), providing a net gain of over Rs 30 billion ($272 million) to the treasury.

FISCAL IMPRUDENCE

¶16. (SBU) The GSL's policy of not privatizing public enterprises

remains unchanged in the 2009 budget. As a result, the government will continue to lose revenue as it bails out failing institutions, including significant losses by the Ceylon Electricity Board (CEB). Of particular interest is the government's decision to spend Rs 6 billion ($54 million) to revive Mihin Lanka, a failed airline named for the President that was forced to cease operations in 2008 after only thirteen months due to significant losses. The GSL has assured citizens that Mihin Lanka will be a profit making venture within three months of recommencing operations in December 2008; however, most believe it will fail again. In the face of severe criticism by the opposition for funding a lost cause, the Minister of Foreign Affairs claimed that there was "no going back when one commences such large scale commercial ventures." He added that the government can afford to pump six billion rupees into the project. The budget also provides the government USD 5 million to build an unnecessary airport in President's constituency in the deep south.

DEBT BURDEN
(DOMESTIC AND FOREIGN DEBT SERVICE)

¶17. (U)

	2007	2008	2009
Rs billions			
Interest payment	183	216	250
-- Domestic	158	189	220
-- Foreign	22	27	30
Amortization	307	383	476
-- Domestic	235	301	391
-- Foreign	71	73	84
Total	490	599	726
--(USD Billions	4.5	5.5	6.6)

Additional items:
Oil hedging losses - NA
Iranian credit line - NA

Sources: Budget 2009, Budget estimates 2009, embassy estimates

¶18. (U) According to the Fiscal Management Report 2009 issued with the budget, the debt/GDP ratio continues to fall. Debt/GDP ratio is estimated at 78.2 percent of GDP in 2008, well below its peak of 106 percent of GDP in 2004. It will likely decline further to 75.6

percent of GDP in 2009. The decline is attributed to moderate growth in debt financing, high inflation, GDP growth in excess of 6 percent, and the stability of the exchange rate. Although debt ratios have been falling, this is offset by the emergence of other risks. Government borrowing in foreign currency has increased. Foreign commercial loans have also increased. Total debt service (excluding payments due for oil purchases) is estimated around 85 percent of projected revenue in 2009; interest payments will be around 29 percent. The Supreme Court, examining public interest litigation (see para 23), said that staggering debt service cost reflects the reckless and irresponsible handling of public finance by the Treasury.

TRANSFERS

¶19. (U) Major programs present in 2008 will continue in 2009. The government will spend Rs 196 billion (up 1.1 percent from 2008) in welfare payments, subsidies, pensions and transfers to state-owned enterprises operating at a loss. The high-cost fertilizer subsidy will continue. (Note: In 2008, the government spent Rs 27 billion on the subsidy; in 2009, the government will likely spend Rs 25 billion, which will now include an extension of the subsidy to small tea plantations owners.) The Samurdhi program, which provides a monthly cash grant to poor families, is another significant transfer program; however, its cost remains unchanged at approximately Rs 11.6 billion in 2009.

INFRASTRUCTURE SPENDING

¶20. (U) Although many analysts have commended the government for its commitment to infrastructure development, in 2008 the government spent only approximately USD 2.5 billion in capital spending, a sum much smaller than budgeted. In 2009, it has approval to expend USD 3.3 billion. Main projects include roads, power, and ports. However, taking into account a lack of liquidity in the global market and the fact that many of these projects are only partly financed by international organizations, the government will have to cut back if unable to raise the necessary capital to finance its portion of these projects.

2009 Budget News and Controversy

¶21. (U) For the first time ever, the budgets of 21 "less significant ministries" were referred to a sub-committee for debate, while the ministries considered "important" were debated in the full house of the Parliament. The sub-committee budgets were approved in Parliament on December 5.

¶22. (U) The main opposition party, UNP, submitted an alternative budget to the press and Parliament. The UNP, which has historically promoted fiscal prudence, promised large subsidies for low income families, massive salary hikes to state workers, additional fertilizer subsidies and other social welfare programs. The party proposed to finance the budget through a flat consumption tax, foreign aid, and interest rate savings. This alternative budget was not reviewed by Parliament.

¶23. (U) The Supreme Court, examining a public interest litigation case, announced on November 4 that it detected flaws in the preparation of the budget accounts. Specifically, expenditures stated in the appropriations bill did not include a debt service of Rs 722 billion; this amounted to an inconsistency with the Constitution. The government, in its defense, said that certain payments allowed by specific laws are not included in the budget bill. Nevertheless, it subsequently submitted a new schedule to Parliament containing debt service costs as directed by the Supreme Court.

¶24. (U) The opposition used the high price of fuel to attack the government. Retail fuel prices were reduced slightly with the new budget, but -- as of December -- Sri Lanka's gasoline and diesel were around 400 percent and 160 percent higher than the Mean of Platts Singapore (MOPS) price. This puts Sri Lanka at a disadvantage compared with other competitors in the region. The UNP charged that the government is making a monthly profit of 50 billion

from petroleum. Responding to these charges the Government said the revenue is being used to fund infrastructure projects. Analysts say there are signs that taxes on petroleum will be used as a major source of revenue to plug holes in the budget next year.

COMMENT:

¶25. (SBU) The 2009 budget contains no real surprises. The government continues to be too optimistic, with unrealistic forecasts of revenue (up 21 percent) and expenditure (up 17 percent) and deficit (6.5 percent of GDP), especially in light of global recessionary conditions. The fact that it passed easily was expected due to the current state of the conflict. Budget discussions, always highly political, included members of the government trying to paint those who would vote against the budget as unpatriotic and unsupportive of military action. Even the UNP, which did vote against the overall budget, begrudgingly abstained rather than vote against the defense budget. The wide margin in the final vote (126 for, 84 against) demonstrates support for the President's plan to continue the war at all costs while moving forward with increasingly protectionist import substitution plans the GSL is selling a beneficial to the "little guy." Sri Lanka may face extreme difficulty in obtaining commercial loans in 2009 to assist in the financing of its deficit. With a continued refusal to even consider IMF assistance in the future, it will need to either significantly revise its forecasts for 2009, or find other sources of funds from bilateral friends, such as China and Iran.